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Ken Sobel

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KEN SOBEL*

INTRODUCTION

There are two ways an owner may receive compensation from the performance bond surety for the contractor's delay. First, the contract or bond may expressly provide for liquidated damages.[1] Second, in the absence of a valid liquidated damages provision, an owner may claim delay damages as he would in any action for breach of contract.

Damages levied against a surety for the contractor's breach are defined and limited by contract law principles. The basic objective of damages is compensation, and applying the law of contracts, the party injured by a breach should receive to the extent possible the equivalent of the benefits of performance.[2] Delay damages accrue when the contractor does not finish the project by the time performance is due. Literally, delay damages means the *cause* rather than the type or elements of the damages. The types of losses compensated by delay damages include lost rental value, lost profits, and increased construction costs.[3]

Damages for breach of contract fall into two categories—general or consequential. General damages are the natural and probable result of the breach. They are expected when the breach occurs, and the plaintiff need not specially plead or prove their existence.[4] Consequential damages, also caused by the breach, are not anticipated under normal circumstances. They must be specially pleaded and proved and based on special circumstances that the parties were

* Ken Sobel & Associates, San Diego, California; B.A., University of Arizona, 1975; J.D., California Western School of Law, San Diego, 1980.

1. For example, $50 for each day past the date set for completion. Aetna Cas. & Sur. Co. v. Butte-Meade Sanitary Water Dist., 500 F. Supp. 193 (D.S.D. 1980).

2. RESTATEMENT (FIRST) OF CONTRACTS § 329 (1932); 11 S. WILLISTON, CONTRACTS § 1338 (3d ed. 1968); CAL. CIV. CODE § 3300 (West 1970).

3. Amerson v. Christman, 261 Cal. App. 2d 811, 68 Cal. Rptr. 378 (1968) (lost rental value); Jen-Mar Constr. Co. v. Brown, 247 Cal. App. 2d 564, 55 Cal. Rptr. 832 (1967) (lost profits); McLeod v. National Sur. Co., 133 Minn. 351, 158 N.W. 619 (1916) (increased construction costs).

4. The measure of damages for breach of a construction contract is usually the cost of completion. 11 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 6331 (1944). *See* Hallenbeck, *Surety's Obligation to Pay Consequential Damages*, 11 FORUM 1201, 1202 (1975) [hereinafter cited as Hallenbeck, *Surety's Damages*].

aware of when the contract was executed.[5] This special circumstances rule is derived from *Hadley v. Baxendale*,[6] the nineteenth century English case, which usually appears in every first-year law school contracts casebook.

The time-honored rule that a surety's liability is co-extensive with its principal's and, in any event, never exceeds the bond's penal limit, remains largely intact.[7] A performance bond surety will nearly always pay no more than the reasonable cost of completion should the contractor default. Nonetheless, with regard to consequential damages, the prevailing trend is to enlarge and broaden the obligations of the surety under a performance bond.[8]

In *Burdette v. Lascola*,[9] the Maryland Court of Appeals found it necessary to trace suretyship law back to the Code of Hammurabi in order to conclude that a corporate surety's liability is to be "interpreted liberally."[10] Some courts have, without any citation, held the surety responsible for consequential damages even though the bond itself only calls for general, cost of completion damages.[11] Fortunately, these courts have at least given due deference to the fundamental nature of suretyship by limiting the obligee's total recovery to the bond penalty. Unfortunately, however, at least one

5. RESTATEMENT (FIRST) OF CONTRACTS § 330 (1932).

6. 156 Eng. Rep. 145 (1854).

7. CAL. CIV. CODE § 2809 (West 1974); Carter v. Bernard, 27 Ohio Misc. 165, 269 N.E.2d 139, (1971); Employment Sec. Comm'n v. C.R. Davis Contracting Co., 81 N.M. 23, 462 P.2d 608 (1969); Walsh v. Int'l Fidelity Ins. Co., 55 Misc. 21 565, 285 N.Y.S.2d 327 (N.Y. Civ. Ct. 1967) (contract of surety is strictly construed; liability is not to be extended beyond the express terms of the bond).

8. Milana, *The Performance Bond and the Underlying Contract: The Bond Obligations Do Not Include All of the Contract Obligations* 12 FORUM 187 (1976) [hereinafter cited as Milana, *Bond Obligations*].

9. 40 Md. App. 720, 395 A.2d 169 (Ct. Spec. App. 1979).

10. *Id.* at 721-22, 395 A.2d at 171:

> Suretyship commenced with the beginning of civilization. References to suretyship are found in the Bible. Although there is evidence of a surety contract as far back as 2750 B.C., and in the Code of Hammurabi, about 2250 B.C., the earliest written contract of suretyship that has been found dates to 670 B.C.
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> By the year 150 A.D., the Romans had developed a "highly technical law of suretyship."
>
> The concept of a corporate surety did not evolve in this country until the late 19th Century. The delay in the development of corporate surety may have been related to the fact that the United States, prior to the latter half of the 19th Century, was primarily an agricultural country. It was not until the Industrial Revolution that the corporate surety emerged.
>
> With the emergence of the corporate surety as a business entity, judicially created rules of interpretation of surety bonds came into being. Two of those rules, . . . are . . . 2) The old doctrine of favoring the surety by construing strictly a claim against him does not apply to the business surety. Its liability is to be interpreted liberally.

Id. (citations and footnotes omitted).

11. *See, e.g.*, Hemenway Co. v. Bartex, Inc., 373 So. 2d 1356 (La. Ct. App. 1979).

court has decided that even this limitation cannot be relied upon. In *Continental Realty Corporation v. Andrew J. Crevolin Co.*,[12] the court went so far as to permit an obligee to recover delay damages in *excess* of the bond's express limit.

Despite the increasing tendency of courts to award delay damages against performance bond sureties, there are decisions that go the other way. The most common reasons given for a court's refusal to award an owner delay damages are the lack of forseeability, express disclaimer, and uncertainty or speculativeness.

Because courts today more frequently expose performance bond sureties to a wider variety of losses, primarily in the area of contractor delay, it is critical for surety law practitioners to be informed on the delay damages issue. The purpose of this Article is to provide an overview of owner delay damages charged to the general contractor's performance bond surety.

In the following sections this Article will discuss recovery of delay damages when they are expressly authorized in the contract or bond, and also when they are not. It will additionally examine the issue of a surety's liability in excess of the bond's penal amount. The concluding section will present cases where courts have denied recovery of delay damages. Before getting into these specific areas, however, an overview of the performance bond is in order.

I. THE PERFORMANCE BOND SURETY

A performance bond ordinarily guarantees the completion of the bonded contract.[13] The performance bond surety agrees to undertake the construction (or share liability therefor) on behalf of a contractor should the contractor default. The surety joins in the contractor's promise to perform and becomes liable along with the contractor when a default of the contract is established. The parties to the performance bond are a contractor and a surety who are the obligors or promisors, and an owner, (occasionally a lender) who is the obligee, promisee, or beneficiary.

The construction performance bond provides assurance to investors and lenders that construction projects undertaken will be completed. For a relatively small price obligees of the bond can shift the risk of the loss of proper completion to a third person, the surety.

Surety companies serve to prequalify contractors, conducting careful investigations to determine their solvency and reliability. By

12. 380 F. Supp. 246 (S.D. W. Va. 1974). *See infra* notes 54-60 and accompanying text.

13. This Article focuses solely upon the performance bond.

requiring a performance bond, the owner brings to bear the independent judgment of a professional third party, which in and of itself is an additional assurance of a successful project. Once the contractor is selected the presence of a performance bond guarantees the cost of the work being purchased from the contractor.[14]

The liability of the surety is mainly governed by the express terms of its bond and, when applicable, statutes.[15] A performance bond usually requires that if the contractor defaults the surety will either step in and complete construction or pay the obligee the reasonable cost of completion, or some variation on this theme. In some instances, however, a "work performance" bond is issued. This bond is narrower than the usual bond guaranteeing faithful performance of the contract because it does not necessarily guarantee that the principal will perform each and every term of the contract.[16] Thus, for example, the surety could argue that its liability on the work performance bond does not include delayed performance, only failure to perform. It is difficult, however, to predict how successful this argument might be. Courts tend to ignore the bond language in delay damages cases.[17] Moreover, as described below, courts are all too willing to simply deem the contract incorporated by reference into the bond.

Courts usually read the underlying contract into the bond to form one integrated obligation of the surety.[18] The same courts then proceed to impose damages caused by the contractor's delays against the surety, although such damages should not be recoverable if the surety's liability were measured solely by the bond's cost-of-completion provision.[19] Few underwriters, however, pay any attention to the underlying contract's terms, which may provide for liquidated or open-ended damages caused by delay.[20]

In most bonds today sureties waive notice of alterations or extension of time for performance given by the owner to the contractor. Such a waiver is found in the American Institute of Architects' standard performance bond, and is widely used throughout the in-

14. Rodimer, *Use of Bonds In Private Construction*, 7 FORUM 235, 237 (1971) [hereinafter cited as Rodimer, *Private Construction*].

15. Metropolitan Cas. Ins. Co. v. Koelling, 57 So. 2d 562 (Miss. 1952) (liability of surety governed by express term and extent of surety's undertaking); CAL. CIV. CODE §§ 2787-2815 (West 1974). *See also, e.g.*, The Miller Act, 40 U.S.C. § 270(a)-270(d) (1976).

16. *See* W. CONNORS, CALIFORNIA SURETY & FIDELITY BOND PRACTICE § 7.5, at 66-67 (California Continuing Education of the Bar 1969).

17. *See infra* notes 42-53 and accompanying text; Hallenbeck, *Surety's Damages*, *supra* note 4, at 1206.

18. *See* Hallenbeck, *Surety's Damages*, *supra* note 4, at 1205.

19. *See* Home Indem. Co. v. F.H. Donovan Painting Co., 325 F.2d 870 (8th Cir. 1963).

20. Milana, *Bond Obligations*, *supra* note 8, at 188.

dustry.[21] In the absence of waiver, material alterations made without the surety's consent will discharge the surety's obligations in whole or in part (although discharge is generally conditioned upon whether the change is material and the extent to which the surety is prejudiced).[22] By waiving notice, however, the surety increases its risk of liability for delay damages because its principal and the obligee may without its knowledge set a completion date that is impossible to achieve. Sureties should not agree to such waivers, but the practice is too well established now to expect change.

When an owner seeks delay damages where no liquidated damages clause exists, he carries the burden of pleading and proving those damages according to the test set forth in *Hadley v. Baxendale*.[23] When, however, an owner seeks to recover delay damages pursuant to a liquidated damages clause, a somewhat different analysis applies. The following section will examine delay damages, expressly provided for in the contract or bond, and the section after will deal with delay as one aspect of consequential damages.

II. DELAY DAMAGES PROVIDED FOR IN PERFORMANCE BOND OR UNDERLYING CONTRACT

An owner's claim for delay damages is often based on an express provision in the bond or the underlying contract. The provision calls for payment of an agreed amount for each period the project's completion is delayed multiplied by the number of periods until the contract is performed. This fixed or stipulated damages clause is enforceable or unenforceable in accordance with local law governing liquidated damages.

When the contract provides for fixed damages in the event of failure to complete within a given time, it is valid only if two elements are established. First, the owner must show that at the time the contract was made it would have been impracticable or extremely difficult for the parties to have fixed actual damages. Second, the fixed amount must not be arbitrary. Unless these requirements are met, the stipulated damage provision will usually be held void and

21. *See* American Institute of Architects, Form A-311; Rodimer *Private Construction, supra* note 14, at 243.

22. For example, prejudice exists where the principal defaults when the job is half done but the owner has paid out the entire contract price, less the retainage. Although the surety is not completely discharged, it is at least relieved of liability to the extent of the overpayment. *See* Walters Air Conditioning Co. v. Firemen's Fund Ins. Co., 252 So. 2d 919 (La. Ct. App. 1971). *See also* McLaughlin Elec. Supply v. Am. Empire Ins. Co., 269 N.W.2d 766, 768-69 (S.D. 1978) in which the contract was amended after the bond was issued, adding a liquidated damage provision and a specified completion date. Such clauses were deemed excised as to the surety and its liability determined without them.

23. 156 Eng. Rep. 145 (1854).

unenforceable as a penalty.[24] When valid, however, a liquidated damage provision for *delay* in performance does not impair an owner's recovery of general damages for the contractor's abandonment of the contract and failure to complete the work. Further, even if the liquidated damages clause is held void as a penalty, the provision may be disregarded as surplusage, and the actual delay damages recovered subject to proof at trial.[25]

When delay occurs and the bond or contract contains a fixed delay damages clause, the issue of apportionment of fault will arise when it appears the owner has contributed to the delay. The older view was that if the owner was at all responsible for the delay, he could not recover any liquidated damages. Recent cases suggest, however, that this rule is being abandoned in favor of apportionment.[26] The rationale behind the trend is similar to the nationwide trend in tort law toward comparative negligence. The courts now tend to view total forfeiture of stipulated delay damages as too harsh, and prefer allocation of the loss according to percentage of fault in causing the delay.[27]

In a typical apportionment case, *Aetna Casualty & Surety Co. v. Butte-Meade Sanitary Water District*,[28] a performance bond surety, Aetna, sued the owner, Butte-Meade, to recover the contract balance, and Butte-Mead counterclaimed for liquidated damages for the contractor's failure to timely complete the project. Aetna argued that liquidated damages were not recoverable because the owner had substantially contributed to the delay.[29]

The federal district court of South Dakota, applying South Dakota law, found that "[o]ther fairly recent federal decisions have supported the apportioning of fault in assessing liquidated dam-

24. McCarthy v. Tally, Inc., 46 Cal. 2d 577, 297 P.2d 981 (1956); Better Food Markets v. American Dist. Tel. Co., 40 Cal. 2d 179, 253 P.2d 10 (1953); Clermont v. Secured Inv. Corp., 25 Cal. App. 3d 766, 102 Cal. Rptr. 340 (1972); 5 A. CORBIN, CONTRACTS §§ 1059, 1063 (1951).

25. *See* 5 A. CORBIN, CONTRACTS § 1056 (1951).

26. Aetna Cas. & Sur. Co. v. Butte-Meade Sanitary Water Dist., 500 F. Supp. 193, 195 (D.S.D. 1980).

27. E.C. Ernst, Inc. v. Manhattan Constr. Co., 551 F.2d 1026 (5th Cir. 1977), *cert. denied*, Providence Hosp. v. Manhattan Constr. Co., 434 U.S. 1067 (1978).

28. 500 F. Supp. 193 (D.S.D. 1980).

29. *See*, Annot. 152 A.L.R. 1349 (1944); *see, e.g.*, Acme Process Equip. Co. v. United States, 171 Ct. Cl. 324, 347 F.2d 509 (Ct. Cl. 1965), *rev'd on other grounds*, 385 U.S. 138 (1966); United States v. Kanter, 137 F.2d 828 (8th Cir. 1943); Glassman Constr. Co. v. Maryland City Plaza, Inc., 371 F. Supp. 1154 (D. Md. 1974); Fruin-Colnon Int'l, S.A. v. Concreto, S.A., 231 F. Supp. 14 (D.C.Z. 1964); Haggerty v. Selsco, 166 Mont. 492, 534 P.2d 874 (1975); General Ins. Co. of Am. v. Commerce Hyatt House, 5 Cal. App. 3d 460, 85 Cal. Rptr. 317 (2d Dist. 1970); Lee Turzillo Contracting Co. v. Frank Messer & Sons, Inc., 23 Ohio App. 2d 179, 261 N.E.2d 675 (Ct. App. 1969); State v. Jack B. Parson Constr., 93 Idaho 118, 456 P.2d 762 (1969); L.A. Reynolds Co. v. State Highway Comm'n, 271 N.C. 40, 155 S.E.2d 473 (1967).

ages."[30] Relying on *E.C. Ernst, Inc. v. Manhattan Construction Co.*,[31] the court concluded that Butte-Meade was entitled to at least a portion of the liquidated damages. The court cited *Ernst* in which the Fifth Circuit applying Alabama law had stated:

> [The rule against apportionment] is an old one whose underlying policies do not remain in full force. One of the dominant reasons underlying it is early judicial hostility to the use of privately agreed upon contract damage remedies. . . . Today, given the increasing complexity of contractual relationships, liquidated damage provisions have obtained firm judicial and legislative support. . . . As long as the owner's own delay is not incurred in bad faith, it is not unjust to allow proportional fault to govern recovery. Generally, owners do not benefit from delays that they incur. Another reason cited in support of the rule is that proving apportionment is simply too difficult. We do not disagree with the difficulty of the task, but recovery should not be barred in every case by a rule of law that precludes examination of the evidence. The district court did not err in allowing apportioned liquidated damages to Providence.[32]

This more liberal view of liquidated damages as demonstrated in *Aetna*, *Ernst*, and similar cases is well intended but is not properly applied. Most jurisdictions construe liquidated damage provisions narrowly because they eliminate the need for the obligee to come forward with evidence of actual damages and are often punitive in nature. The apportionment jurisdictions ignore the general policy against liquidated damage provisions and barely give lip service to the penalty issue. The apportionment courts should require the obligee to prove that the provision is not a penalty because even if they strike the clause an obligee may still recover delay damages—if he bears the burden of pleading and proving injury as any other litigant must do.

When the parties fail to provide an express liquidated damage provision, or when the provision exists but is declared unenforceable as a penalty, an owner may yet recover delay damages.[33] He must, however, plead and prove that the delay caused him actual injury and that the injury was foreseeable to the surety at the time the contract or bond was entered into.

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30. *Aetna*, 500 F. Supp. at 196.

31. 551 F.2d 1026 (5th Cir. 1977), *cert. denied*, Providence Hosp. v. Manhattan Constr. Co., 434 U.S. 1067 (1978).

32. 500 F. Supp. at 196-97 (citations and footnotes omitted), *Ernst*, 551 F.2d at 1038-39.

33. *See*, Hemenway Co. v. Bartex, Inc., 373 So. 2d 1356 (La Ct. App. 1979); 5 A. CORBIN, CONTRACTS § 1056 (1951).

III. DELAY: ONE ASPECT OF CONSEQUENTIAL DAMAGES

According to *Hadley v. Baxendale*,[34] damages for breach of contract are limited to damages arising directly from the breach, plus those arising from special circumstances known to the parties at the time of contracting, which they should have reasonably contemplated.[35] Knowledge is required to recover consequential damages because a party cannot be expected to assume limitless responsibility for all consequences of a breach. He should be advised of the facts at the outset in order to determine whether to accept the risk of contracting, and if so, the price to be assessed therefor.

In the typical performance bond arrangement the special circumstances necessary for the recovery of delay damages are practically built in. For example, the construction contract usually sets forth the intended use of the project, a definite time for completion and a "time is of the essence" clause. When these terms are present the contractor is deemed notified that timely performance is mandatory. When he does not complete on time and the owner seeks to recover consequential delay damages, most courts find the requisite special circumstances in the express contract terms. Under these facts, many courts have also held the surety responsible for the contractor's delay.[36] The courts that have done so utilize a two step process, not necessarily in the following order: First, they determine whether the surety can be charged with knowledge of the contract terms. The bond, nearly always, refers expressly to the contract, so the courts conclude that the contract has been incorporated by reference into the bond. And, even when the bond does not mention the contract, some courts simply conclude that it is impliedly integrated into the bond.[37] Second, they purport to rely on the threadbare rule that a surety's liability is co-extensive with that of its principal.[38] Since the court probably has already determined that the contractor is liable, the surety will also be liable.

For a better understanding of how the special circumstances rule applies to the performance bond situation, an examination of the cases is necessary. Before proceeding to the case analysis, however, a comment by one author may explain why the courts have increas-

34. 156 Eng. Rep. 145 (1854).

35. RESTATEMENT (FIRST) OF CONTRACTS § 330 (1932); Gerwin v. Southeastern Cal. Ass'n of Seventh Day Adventists, 14 Cal. App. 3d 209, 220, 92 Cal. Rptr. 111, 118 (1971) (seller's knowledge as to purchaser's particular needs at time of breach insufficient).

36. Hallenback, *Surety's Damages*, *supra* note 4, at 1206.

37. *See, e.g.*, Hemenway Co. v. Bartex, Inc., 373 So. 2d 1356 (La. Ct. App. 1979).

38. Robinhorne Constr. Corp. v. Snyder, 113 Ill. App. 2d 288, 251 N.E.2d 641 (1969), *aff'd*, 47 Ill. 2d 349, 265 N.E.2d 670 (1970); Amerson v. Christman, 261 Cal. App. 2d 811, 825, 68 Cal. Rptr. 378, 388 (1968).

ingly taken the liberal approach toward awarding delay damages to owners:

> Since the natural objective of a building contract is the construction and use of certain proposed premises, the courts have not had much difficulty in finding that the owner, innocently deprived of the enjoyment of his building, has sustained some form of consequential damage at the hands of the breaching contractor.[39]

IV. CASES HOLDING THE SURETY LIABLE FOR OWNER'S DELAY DAMAGES

MacLeod v. National Surety Co.,[40] a Minnesota case, is the first reported decision where a surety was held liable for delay damages. There, a general contractor, MacLeod, sued his subcontractor's performance bond surety, National, for damages caused by the subcontractor's delay in delivering structural ironwork necessary for MacLeod to meet his contract completion date.[41] The court upheld a jury's award of consequential damages against the surety, stating that "[t]he question whether plaintiffs are entitled to recover the items of damage claimed does not require extended discussion."[42] Thus, the court permitted MacLeod to recover his increased expenses in constructing the building, interest on funds withheld by the owner, expenses incurred in expediting delivery of the ironwork, and the cost of heating the building during the delay to protect other work from weather damage. While the court generously compensated MacLeod, it never mentioned whether his subcontractor's surety knew or had any reason to know that MacLeod would suffer to such an extent if the subcontractor failed to perform.

In the California case of *Amerson v. Christman*,[43] Amerson, a property owner, brought a declaratory relief action against Christman, his general contractor, and Hartford Accident and Indemnity Company, Christman's performance bond surety. Christman was obligated to complete construction of Amerson's house by August 9. During construction, Amerson became disenchanted with Christman's deviations from the plans and specifications and told Christman and his surety as much. Christman stopped work on June 12, and June 17 Amerson notified the surety

39. Hallenbeck, *Surety's Damages*, *supra* note 4, at 1206 (footnote omitted).
40. 133 Minn. 351, 158 N.W. 619 (1916).
41. The same reasons supporting an owner's right to recover delay damages against the prime contractor's surety also support the prime contractor's recovery against his sub's performance bond surety. Appleman cites this case for the proposition that an *owner* can recover delay damages against the performance bond surety. 11 J. APPLEMAN, INSURANCE LAW & PRACTICE § 6333 (1944).
42. 133 Minn. at 354, 158 N.W. at 621.
43. 261 Cal. App. 2d 811, 68 Cal. Rptr. 378 (1968).

of Christman's default. Although Christman later returned to the job, work proceeded "on-again, off-again" for over two years until a lawsuit filed by Amerson came to trial.

At trial Amerson moved to amend his complaint to add a claim for consequential damages against Christman and his surety for Christman's delay. Although that motion was denied, the trial court decided that Christman had breached his contract and Amerson was entitled to recover the cost of completion from Christman and his surety. All parties appealed.

On appeal, the California Court of Appeal upheld the trial court's refusal to permit the complaint to be amended.[44] Nevertheless, the appellate court independently examined the record and held that Amerson's "uncontroverted" testimony supported an array of consequential delay damages claims against the surety.[45]

To decide whether the surety should also be liable for delay damages the court made the following observations: First, it noted the old rule that the surety's liability is coextensive with its principal's. Next, it found that the bond incorporated the construction contract by reference,[46] and the contract provided for timely performance. The court bolstered its conclusion by pointing to the following language in the bond: "Hartford is obligated to make available sufficient funds to pay the cost of completion less the balance of the contract price; but not exceeding, *including other costs and damages for which the surety may be liable hereunder*, the amount set forth above."[47]

The court did not say why this language made the surety liable. It is obvious that the provision was intended to limit the surety's liability, not expand it. In any event, the court concluded that Hartford was "equally liable" with Christman for damages "consequentially caused by the contractor's breach," primarily damages for delay.[48]

The court, never mentioning whether the damages were foreseeable at the time the contract was executed, allowed consequential

44. *Id.* at 824, 68 Cal. Rptr, at 387. Because the case had been tried as though the issue were before the court, and Amerson's complaint had sought broad declaratory relief, the court found it unnecessary to decide whether the amendment to the complaint should have been allowed. Instead, the court concluded, the trial court should have exercised its "broad equitable powers" permitting Amerson recovery for consequential damages.

45. It is surprising that the surety allowed *any* evidence of consequential loss to get in the record, but not surprising that the evidence was "uncontroverted."

46. 261 Cal. App. 2d at 825, 68 Cal. Rptr. at 388. The bond stated that the surety would be "bound unto" Christman in the event Christman did not "perform the covenants, conditions and agreements," of the construction contract.

47. *Id.* (Emphasis added by the court).

48. *Id.*

delay damages against the surety for: (1) rain damage to the interior of the house; (2) loss of use (rental value); and (3) additional costs of providing other housing for Christman's mother and son.

In the Louisiana case of *Costanza v. Cannata*,[49] Cannata agreed on March 31 to build a small commercial building for Costanza by June 23. Cannata agreed to perform in a workmanlike manner in accordance with certain plans and specifications and to pay three dollars a day as liquidated damages if he failed to complete on time. New Amsterdam Casualty Company furnished a performance bond.

Costanza learned that Cannata was not complying with the plans and specifications, and, on several occasions, told him so. Cannata did not appreciate Costanza's intervention and left the job several times in a huff. Costanza reported his absences to the surety. Meanwhile, heavy rains and Cannata's delays slowed the job. As a result, the building was not accepted by Costanza until July 14, and then only on condition that Cannata cure a few defects. When the surety saw the estimates to cure, it balked. Costanza ultimately sued Cannata and the surety and was awarded delay damages against both, including loss of use, weather damage to the building, and the increased costs of completion. On appeal, the Louisiana Supreme Court affirmed the judgment against the surety. In so holding, the court discussed neither the terms of the bond or the contract nor the question of foreseeability. Instead, the court stated simply that the surety knew of Cannata's failure to perform and was notified of defective construction work and therefore "assumed the risk" of liability by failing to step in. As the court stated:

> When the contractor was formally notified in writing on August 4, 1941, with a copy to the surety, of the items that had to be corrected and completed, and the bonding company was thereafter furnished with three estimates secured by the plaintiffs for such work but did not authorize the plaintiffs to have the building completed under one of these bids, it assumed the risk attendant upon the possibility that a delay in having the work done would result in an increase in the ultimate cost because of fluctuating costs and cannot now be heard to complain . . . .[50]

In *Hemenway Co. v. Bartex, Inc.*,[51] Hemenway engaged Bartex on January 23, 1973, to build a new retail furniture store for $557,000, with Highlands Insurance Company as performance surety. The bond was attached to the contruction contract, which provided for a specific completion date.

The building was not ready for occupancy until nearly one year

49. 214 La. 29, 36 So. 2d 627 (1948).
50. *Id.* at 38, 36 So. 2d at 630.
51. 373 So. 2d 1356 (La. Ct. App. 1979).

after the specified completion date. Hemenway accepted the building and then sued Bartex and Highlands seeking, among other things, recovery of consequential damages caused by Bartex's delay in completion. Bartex and Highlands tried to hide behind a liquidated damages clause but failed because the parties had not filled in a crucial blank in the construction contract. The trial court permitted Hemenway to introduce evidence of his damages caused by the delay. After trial on the merits, Hemenway obtained judgment against both Bartex and Highlands. As damages for delay the trial court awarded Hemenway about $25,000 as reimbursement for the rental of its old store during the delay and about $16,000 for additional interest paid on the interim financing. In upholding these delay damages the court did not mention whether they were forseeable. Although there is absolutely no discussion of why the surety was also held liable for Bartex's delay, it was probably because it had physically attached its bond to the construction contract and thereby incorporated it—and all the contract's obligations—into its bond by reference.

The previous cases point out some of the circumstances in which the surety has been liable for delay damages caused by its contractor. Liability was premised on the contractor's breach of duty alone, and the delay damages assessed against the surety were expressly limited to the amount of the bond. The next section deals with what can best be described as the surety attorney's nightmare: delay damages in excess of bond limits.

V. Excess Liability for Surety's Delay

Most surety attorneys accept as universally true the proposition that the surety on a construction performance bond is liable only up to the express limit of its bond. After 1974, however, the rule is more precisely stated as follows: The surety is never liable in excess of bond limits, except when it is.

The exception may occur, according to one court, when the surety itself is found to have delayed in carrying out its contractual duties.[52] This theory of excess liability for surety delay appears limited for the moment to one particular kind of performance bond which calls for an election on the part of the surety in the event of contractor default.[53] Under this type of bond, the surety must, upon its contractor's default, within a certain number of days either take over completion of the contract or immediately pay the owner the reasonable cost of completion. The surety's delay, according to

52. Continental Realty Corp. v. Andrew J. Crevolin Co., 380 F. Supp. 246 (S.D. W. Va. 1974).

53. Default occurs when a court, using 20/20 hindsight, says it does.

one court, in making the election exposes it to both general and consequential delay damages *in excess* of the bond limit.

In *Continental Realty Corporation v. Andrew J. Crevolin Co.*,[54] an owner brought suit against a contractor and its performance bond surety for breach of a building contract. The bond provided that the surety, in the event of contractor's default, would:

> (a) Within fifteen (15) days of determination of such default take over and assume completion of said contract and become entitled to payment of the balance of the contract price, or (b) pay Obligee in cash the reasonable cost of completion, less the balance of the contract price including retained percentage. The cost of completion shall be fixed by taking bids from at least three responsible contractors chosen by Obligee and Surety. Surety will make such payment within fifteen (15) days after the cost of completion shall have been so determined.[55]

The contract as amended called for construction of a motel to be completed by April 20, 1973. In early April, 1973 the completion date was extended to June 15, 1973, based on the contractor's assurances of performance, but work later ceased because of a strike precipitated by the contractor's failure to meet a subcontractor's payroll. On July 12, 1973, after the owner had made "continuous and unsuccessful" demands on the contractor to perform its obligations, the architects formally certified a default and called upon the surety to intervene.

The surety responded to the notice of default by a letter dated July 26, 1973, which pontificated that a surety owed no greater duty to an obligee than the principal did. Nothing more was done until November, 1973 when the surety attempted to secure bids for completion of the project. For a variety of reasons the four bids received were unacceptable, so the surety did nothing—and the owner sued.

The federal district court, applying West Virginia law, found the contractor and surety jointly and severally liable for breach of the contract based on lack of completion and defective construction. The court also decided that the surety was *separately* liable for its own breach of the performance bond. It construed the quoted bond provision as imposing the affirmative duty on the surety to either assume performance of the contract and complete the project or pay for the cost of completion.[56] Having failed to do either, the surety breached its bond and became liable for all consequential damages incurred by the owner.

As one commentator explained:

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54. 380 F. Supp. 246.
55. *Id.* at 251.
56. *Id.* at 252.

> It appears that the overriding theme of the decision is that the penal amount of the bond limits the surety's liability only for the principal's breach of the underlying construction contract, but that the bond penalty does not limit the liability of the surety on its own bond. Thus, the court says that the surety's liability at the moment of the principals default "may well have been limited" to the bond penalty. But, says the court, thereafter the surety was obligated to either actually complete the job at whatever cost might be involved (and the court recognized this could well exceed the bond penalty), or to pay the cost of completion in the manner required by the bond, and in the time provided. If the surety chose the latter route, the court implies that its liability would still have been limited to the bond penalty. But the surety failed to so pay, and as a consequence, the court viewed the surety's failure to pay or to complete as a separate breach (a breach of the bond, as opposed to a breach of the bonded contract), with the surety being liable for all consequential damages flowing therefrom.[57]

Not only did the *Crevolin* court impose liability against the surety for its delay but it also tacked on an impressive array of "delay" damages, loosely categorized as consequential or special damages, greatly in excess of the bond limits. The court was unabashedly cavalier in stating that "the Court's conclusion that liability against [the surety] extends in amounts beyond the penal sum of the bond is neither new or novel in the light of simple contract law."[58] No authority for this "well accepted" proposition was cited. Yet, the court then proceeded to assess the surety for the following delay damages: (1) increase in the cost to complete after January, 1974 and interest from the date of trial; (2) costs of winterizing and security; (3) increased interest costs for interim construction financing; and (4) lost profits.

By most standards, the failure of the surety to take any action in *Crevolin* was, admittedly, culpable. Nevertheless, the punishment exceeded the crime. And worse, the case as precedent has created a real dilemma. As stated by Mr. Wisner:

> To me, the most obvious problem with the "Rule of *Crevolin*" is that the surety is forced to act at its peril once it executes a bond of the type involved and a default is declared. Suppose, for example, that a very competent contractor has his problems with the owner or architect, and is declared in default. Such situations are not uncommon. The contractor may tell you (the surety) that the owner or the architect is wrong, and that you should refuse to step in. If you do step in, you may be losing your indemnity, and perhaps even inviting the contractor to sue

57. Wisner, *Liability In Excess of the Contract Bond Penalty*, 43 INS. COUNSEL J. 105, 107 (1976) [hereinafter cited as Wisner, *Liability*].

58. 380 F. Supp. at 253.

> you. If you do not step in, some court may someday hold you liable for liability in excess of the bond penalty. Aside from not executing bonds of the *Crevolin* type, it seems that the surety has no satisfactory answer to a very difficult problem.[59]

Wisner later concludes that the *Crevolin* doctrine is an example of the extension of the "bad faith" theory of recovery from insurance law to suretyship. This analogy is accurate. The *Crevolin* court did not merely apply time-honored contract law principles to reach its decision; it *sub silentio* held that a surety's delay constituted an independent breach of duty, sounding in tort, which exposed the surety to open-ended delay damages. At least two cases before *Crevolin*[60] and one after[61] apparently relied on the independent breach doctrine to hold the surety liable for consequential and delay damages.

In *Bill Curphy Co. v. Elliott*,[62] Curphy, the prime contractor, entered into a subcontract with Elliott who provided a performance bond which gave the surety the option to complete the subcontract or tender an alternate contractor to complete the work should Elliott default. Elliott defaulted, and the surety did nothing. In litigation, the Fifth Circuit, applying Texas law, ruled that the surety's failure to elect exposed it to consequential damages, but limited the total recovery to the bond penalty.

Miracle Mile Shopping Center v. National Union Indemnity Co.,[63] is technically not "on point," as pointed out by Wisner, because excess liability was not, as least expressly, an issue in the case.[64] Wisner's observation is accurate. In fact, although the trial court, applying Indiana law, awarded the obligee an excess judgment against the contractor, it reduced the judgment as against the surety to the bond limits. On appeal, however, the surety contested liability for consequential and delay damages approved by the court below. The Seventh Circuit was not persuaded. Instead, it upheld the general damages of the cost to complete, plus consequential damages which included increased costs of mechanical services and interest from the date of default.

In *Hunt v. Bankers & Shippers Ins. Co.*,[65] the surety issued per-

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59. Wisner, *Liability*, *supra* note 57, at 108.

60. Miracle Mile Shopping Center v. National Union Indem. Co., 299 F.2d 780 (7th Cir. 1962); Bill Curphy Co. v. Elliott, 207 F.2d 103 (5th Cir. 1953).

61. Hunt v. Bankers & Shippers Ins. Co., 73 A.D.2d 797, 423 N.Y.S.2d 718 (App. Div. 1979), *aff'd*, 50 N.Y.2d 938, 409 N.E.2d 928, 431 N.Y.S.2d 454 (1980). *See* Wisner, *Liability*, *supra* note 57, at 109.

62. 207 F.2d 103 (5th Cir. 1953).

63. 299 F.2d 780 (7th Cir. 1962).

64. Wisner, *Liability*, *supra* note 57, at 106.

65. 73 A.D.2d 797, 423 N.Y.S.2d 718 (App. Div. 1979), *aff'd*, 50 N.Y.2d 938, 409 N.E.2d 928, 431 N.Y.S.2d 454 (1980).

formance bonds covering the construction of two restaurants which were to be built for sale to the Ponderosa restaurant chain. (The surety also signed a letter agreement in which it agreed to complete the construction projects if the general contractor defaulted. It is unclear at what stage this letter was signed or how it affected the outcome of the case). Upon the contractor's default, the surety took no action either to complete or pay the reasonable cost of completion as required by the bond. Ultimately the owner stepped in and completed. Meanwhile, the owner was forced to reduce the purchase price of the restaurants because the contractor's delay had caused him to breach the sale agreement. The owner sued the surety for its independent breach of the performance bond, asking for direct damages and delay damages measured by the reduced price. The trial court ruled for the owner and, on one performance bond, awarded him $3,000 *in excess* of the bond's limit—*Crevolin* revisited.

On appeal, the Appellate Division of New York's Supreme Court, in a brief memorandum decision, wasted no time in reducing the excess award against the one bond to its limits, recognizing the continued vitality of the principle that "the amount recoverable from a surety shall not exceed the amount specified in the undertaking."[66] The court, however, citing *Miracle Mile* for the rule that the surety *who fails to perform* is liable for all damages which "reasonably and naturally" flow "from the contractor's breach, as well as its own,"[67] held that the surety could be liable for the rental value of the structure during the period of delay. The court upheld the trial court's award of damages for the forced reduction in purchase price resulting from the delay, however, because "loss of rents would have exceeded the loss suffered as a result of the forced reduction of the sale price of the restaurants . . . ."[68] Thus, the surety benefited from the owner's efforts to mitigate its damages.

Curiously, the *Hunt* court did not cite *Crevolin*. Analysis of the *Hunt* decision by surety lawyers yields as many divergent views as a football game's crucial fourth down play by Monday-morning quarterbacks. Why did the *Hunt* court not mention *Crevolin*? It is hard to believe that the court or the parties failed to discover it in researching the issue.[69]

The author's hope is that indeed the *Hunt* court was aware of *Crevolin*. But, like the last leaf of autumn, the *Crevolin* decision

66. *Id.* at 797, 423 N.Y.S.2d at 720.
67. *Id.* at 798, 423 N.Y.S.2d at 720.
68. *Id.*
69. The *Crevolin* opinion was published five years before *Hunt*. *Crevolin* is found in West's General Digest (5th ed.) under key number "Suretyship and Guaranty 82(2)," the same key number where *Hunt* is found.

hangs there, defying both reason and precedent. In short, the *Hunt* court probably found *Crevolin* easier to ignore than to discuss.

Beyond all that, the court in *Hunt* did say that the surety would not have been liable for delay damages at all if it had *done something*, not just failed or refused to act. This is an important practical lesson for surety practitioners.

Although there is no certain solution to avoiding an excess-liability problem, the following advice is offered by Wisner: If possible, the surety should re-word the bond itself, by adding to a *Crevolin* type bond something to this effect: "In any event, the surety's liability is limited to the aforestated bond penalty amount." If this is not feasible, then underwriters, adjusters, and counsel must maintain careful supervision over projects covered by a *Crevolin*-type bond. Consider the consequences of not completing or paying. Once a default has been declared, a more prudent approach would be to tender the bond penalty and make a claim on your indemnity agreement.[70] That assumes, of course, that you are right in deciding the owner is right and the contractor is wrong.

The two preceding sections gave you the bad news. Now for the good news. Reported cases do exist where the owner did not recover delay damages. The following section will discuss those decisions.

VI. Cases Holding the Surety Not Liable for Delay Damages

Three grounds exist for denying recovery of consequential damages. First, no special circumstances existed so that the alleged injuries were not foreseeable, or if they were, they were not known to the defendant. In one case, *Southern Fireproofing Co. v. R.F. Ball Construction Co.*[71] decided by the Eighth Circuit Court of Appeals, the contractor was held not liable for delay damages under Iowa law where adverse subsurface conditions of the construction site were the actual cause for the delay, and those conditions were not foreseeable at the time the contract was signed. The co-defendant surety was also exonerated on the ground that its liability was co-extensive with the contractor—contractor not liable, therefore, surety not liable.[72]

In a case decided by the Texas Court of Civil Appeals, *New Am-*

70. *See generally* Wisner, *Liability*, *supra* note 57, at 109.

71. 334 F.2d 122 (8th Cir. 1964).

72. *See also*, New Amsterdam Cas. Co. v. Bettes, 407 S.W.2d 307, 316-17 (Tex. Civ. App. 1966) (evidence failed to support finding that surety knew of obligee's complicated financial arrangements); Ben Agree Co. v. Sorensen-Gross Constr. Co., 365 Mich. 185, 111 N.W.2d 878, (1961) (adverse weather conditions).

sterdam Casualty Co. v. Bettes,[73] a construction lender, Bettes, sought consequential damages allegedly occasioned by delay in completion of a construction project. Bettes was a co-obligee of a dual-obligee performance bond. Before construction started the project was sold, and the purchaser entered into a long term lease with a third person. Both the purchase agreement and lease each required that construction be completed on time and certain construction specifications be met. The contractor defaulted (and the proposed tenant backed out), so the obligee, besides having to complete, had to renegotiate downward the purchase contract and find the buyer permanent financing.

Bettes sued both contractor and surety for loss of rental value measured by the reduction of the contract price and cost to obtain new financing. The trial court allowed Bettes' claim, but the Texas Court of Appeals reversed. The appellate court appears to have held (in a confusing opinion), among other things, that the surety neither knew nor reasonably could have known of Bettes' complicated financing scheme at the time the bond was executed.[74] The court found that Bettes' damages were not caused by the delay but instead were caused by the collapse of his financing arrangement. Because the arrangement itself was unknown to the surety, its collapse was not forseeable and consequential damages were not recoverable.

The *Bettes* opinion also points out that delay damages for loss of rental value are limited to a *reasonable* rental over a *reasonable* period of time.[75] This is an important point. Courts applying this rule should not allow an owner to sit back and do nothing in hopes of recovering damages for the actual period of delay. Instead, a mitigation-of-damages rule will be applied, and the owner's recovery will be limited to damages over a *reasonable* period of time.

Second, the surety bond or contract may expressly *disclaim* liability for consequential damages. In *Mayer v. Alexander & Baldwin, Inc.*,[76] Alexander & Baldwin, ("A&B") furnished a construction performance bond on four separate construction contracts. The contractor abandoned the project after partial performance of each contact. A&B notified the several owners that, as surety, it would complete the work. Each of the contracts contained a "time is of the essence" clause and each of the performance bonds contained an express disclaimer of the surety's liability for delay damages which stated: "PROVIDED, ALSO, that the Surety shall not be liable

73. 407 S.W.2d 307 (Tex. Civ. App. 1966).
74. *Id.* at 317.
75. *Id.* at 315-16.
76. 56 Hawaii 195, 532 P.2d 1007 (1975).

. . . for damages caused by delay in finishing such Contract."[77] Mayer sued for delay damages and argued that (1) the "time is of the essence" clause contradicted the exculpatory clause, and (2) public policy dictates that an exculpatory clause should be narrowly construed. The trial court rejected Mayer's argument, and Mayer appealed.

The Supreme Court of Hawaii affirmed. In so doing, the court cited an earlier case, *Territory of Hawaii v. Pacific Coast Casualty Co.*,[78] which had held: "There is no principle of law better settled than that a surety has the right to stand upon the very terms of his contract."[79]

In an analogous case, the Appellate Division of New York's Supreme Court held that a delay damages exculpatory clause contained in a construction contract protected both contractor and surety. In *Lamparter Acoustical Products Ltd. v. Maryland Casualty Co.*,[80] a subcontractor sued to recover delay damages from the prime's surety. The agreement between the prime and sub provided that the prime would not be liable for delay damages. The trial court granted summary judgment against the surety, allowing the sub to recover delay damages, and an appeal followed.

In reversing, the Appellate Division, in a memorandum decision, stated:

> It is fundamental that a surety's liability . . . is limited to the liability of the contractor. In the underlying [subcontract] agreement, . . . the subcontractor expressly agreed that the general contractor would not be liable for delay damages. Thus, the surety cannot be held liable for delay damages . . . .[81]

The third ground for denying an owner delay damages is the general principle that "[n]o damages can be recovered for a breach of contract which are not clearly ascertainable in both their nature and origin."[82] In other words, damages must not be too speculative, remote, or uncertain. To recover, an owner must prove with reasonable certainty that his damage resulted from the breach.[83]

In *Gurney Industries, Inc. v. St. Paul Fire & Marine Insurance Co.*,[84] the Fourth Circuit Court of Appeals, applying North Carolina law, denied owner Gurney's claim for lost profits as too speculative. Gurney claimed that the contractor's delay and poor

77. *Id.* at 197, 532 P.2d at 1008-09.
78. 22 Hawaii 446 (1915).
79. 56 Hawaii at 198, 532 P.2d at 1009 (*citing* 22 Hawaii at 450).
80. 64 A.D.2d 693, 407 N.Y.S.2d 579 (App. Div. 1978).
81. *Id.* at 693, 407 N.Y.S.2d at 580.
82. *See also* CAL. CIV. CODE § 3301 (West 1970); C. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 26 (1935);
83. CAL. CIV. CODE § 3301 (1970).
84. 467 F.2d 588 (4th Cir. 1972).

workmanship in constructing a yarn mill had caused him to lose profits from his knitting mill operations. The court, however, found that the yarn was to be manufactured solely for Gurney's knitting mill, and no comparable market existed to determine the value of yarn. Further, Gurney could have obtained comparable yarn at comparable prices on the open market. Accordingly, delay damages were held to be too speculative. (The court, however, remanded for a determination of any *operating losses* caused by the contractor's breach).

In *Exten Drive-In, Inc. v. Home Indemnity Co.*[85] despite a "time is of the essence" clause in a drive-in theatre paving contract, and a delay in completion of over four months, the Pennsylvania Supreme Court, in a split decision, denied the owner's claim for lost profits because the movie screen, which was constructed under another contract, was not installed until after the paving was done so the theatre could not have been opened sooner. The court further held that even if the delay in paving had delayed opening, the business was so new that any claim of lost profits was sheer speculation.

The cases presented in this section demonstrate that when it comes to challenging delay damages all is not lost. When confronted with a claim for delay damages, first, examine the language of the bond and underlying contract; second, ask whether the damages were foreseeable at the time the contract was formed, third, check to see whether either the contract or bond has an exculpatory clause, and finally, carefully examine the facts and circumstances surrounding the owner's claim to see whether his alleged damages are sufficiently certain.

CONCLUSION

Courts increasingly charge performance bond sureties with owner delay damages. They tend to do so despite contrary provisions in the bond and against the grain of long established principles of contract damages.

In the area of liquidated damages, we have witnessed a departure from the usual rule of strict construction and the presumption against validity. Now, courts simply pass the hat and allow apportionment according to fault, usually without considering first whether the clause is valid.

When the parties have not expressly provided for delay damages, the courts purport to apply the special circumstances test. Yet, upon analysis, it is obvious that courts tend to focus more on catch-all phrases and vague generalities than the facts of the case, as is

85. 436 Pa. 480, 261 A.2d 319 (1969), *cert. denied*, 400 U.S. 819 (1970).

called for in *Hadley v. Baxendale*. Moreover, the courts usually fail to pay attention to the precise terms of the bond and underlying contract or to state in detail their reasons why the terms give rise to delay damages or not.

The excess liability imposed in the *Crevolin* case was unprecedented, but, happily the case has not been followed. As suggested, sureties could help avoid being liable for damages in excess of the limits of their bonds by more careful drafting.

On the brighter side, the courts will require the owner to plead and prove both forseeability and certainty to recover delay damages; and, if the surety has been clever enough to include a disclaimer of consequential damages in its bond, it will be enforced.